

**REPORT TO THE SECRETARY OF THE TREASURY
FROM THE
TREASURY BORROWING ADVISORY COMMITTEE
OF THE
BOND MARKET ASSOCIATION**

August 1, 2006

Dear Mr. Secretary:

Since the Committee's previous meeting in May, the economic expansion has cooled from its brisk pace at the start of the year. Growth slowed to a 2½% annual rate in the second quarter, reflecting the drag from higher energy costs, diminishing strength in housing and the fading influence of special factors that boosted activity over the winter. Although monetary policy has become less accommodative, financial conditions are providing a reasonably supportive backdrop for growth near its sustainable trend over coming quarters.

The softening in housing may continue to temper overall growth near term. Sales of homes are down 9% from their peaks, leaving a large overhang of supply that is curbing construction and dampening home prices. The latter could reinforce a slowing in consumer spending. After contributing a half percentage point to growth in 2004 and 2005, residential investment declined at a 6.3% annual rate in the second quarter and is likely to remain at low ebb for a time.

Nonetheless, consumer confidence remains cautiously optimistic in part on signs that job availability is holding up during this latest energy crunch. Business profits and balance sheets remain buoyant. As of July 27, with about 65% of S&P 500 companies reporting, 81% had met or exceeded expectations for the second quarter as profits continued to rise at a double digit pace.

Inflation pressures have accelerated this year, characterized by further increases in energy prices and evidence that higher costs for fuel and materials are boosting underlying inflation. Core measures have risen at 2½-3% rates in the first half. Nonetheless, with monetary policy closing off lingering upside risks, inflation expectations have been well behaved and the prospect of cooling demand suggest price pressures could abate somewhat, particularly if energy and commodity prices plateau.

Yields on U.S. Treasury securities have backed down from recent cyclical highs as earlier concerns about overheating have eased. Forward rates reflect a much-reduced prospect of any additional Fed rate hikes this year and anticipate some slight retracement in 2007.

The improving trend in the Federal budget deficit continues with both official and private estimates for FY2006 coalescing near the \$300 billion mark. A strong cyclical recovery

has provided outsized strength to tax receipts, but public spending, especially on health care, also is rising.

Against this economic and financial backdrop, the Committee considered its charge.

In the first section of the charge, the Treasury provided the Committee with a brief update on its efforts to create a quantitative framework or model for evaluating its portfolio of marketable debt securities.

The Debt Management Model has progressed from a conceptual framework to a beta test version—albeit a model that is still very preliminary. The Treasury provided the Committee with an expanded summary of the model—its key inputs and potential outputs and solicited suggestions on the types of model outputs that would be useful in guiding future policy making.

With respect to specific outputs of the model, a number of members suggested that average maturity of the debt be included even while other proposed outputs such as the interest cost of the debt and its variability already capture some of the attributes of this measure.

Several members pointed out that for the model to be successful that certain constraints would need to be articulated. An example of such a constraint might be to keep the issuance amount of specific maturity securities within a defined range.

Other members pointed out the need to identify specific forecast horizons and to develop reasonable variances of inputs around a baseline level.

Finally, one member highlighted the need for Treasury to devote resources to better project the level and variability of tax receipts which have varied widely and may make the value of any model, no matter how robust, ineffective.

In the second part of the charge, the Treasury solicited the views of the Committee with respect to a shift to a quarterly 30-year bond auction cycle beginning in February 2007. A bar chart was presented to members highlighting the variability of interest rate risk offered at Treasury refundings since February 1985 as well as its average level over that period. Another chart showed the projected average maturity of issuance and average maturity of outstanding debt assuming quarterly 30-year bond issuance through 2011.

Committee members' opinions varied with regard to the necessity of and the timing of transitioning to a quarterly auction cycle. Members generally agreed that for liquidity purposes an adequate supply per auction would need to be maintained by Treasury. Some members quantified minimum size constraints per cusip at \$10-12 billion in the current environment. One member suggested that insufficient demand and/or trading volume had been demonstrated to warrant any increased supply. Others, however, mentioned that liability based investing trends in the long end by pension plans was increasing at a reasonable pace and would likely continue. One member pointed out that

traditional measures of liquidity, such as average daily trading volume, might be less important for the long end of the market due to the nature of the buyers being primarily buy and hold investors looking to hedge long-duration liabilities. While some members found the proposition of shifting to a quarterly auction frequency with larger notional supply unnecessary or ill-timed, most felt that it was appropriate, would augment liquidity in long-dated strips and be well received by the market.

In the third part of the charge, Treasury asked for the Committee's views on the appropriate role of Treasury as a regulator in the Treasury market when liquidity in specific securities is reduced artificially by market participants.

There was a widely held opinion on the Committee that the Treasury already has several powerful and effective tools to regulate the Treasury market and that no additional tools were necessary. It was further widely held that the Treasury should focus its attention on utilizing these tools in the avoidance of systemic settlement fails where market liquidity is severely and artificially reduced by certain market participants and not used simply to ensure that financing costs on specific issues remain stable.

Several members pointed out that the Treasury's use of "suasion" and large position reporting in the past has been very effective in both resolving systemic fails and ensuring that they rarely occur.

Other members pointed out that the Treasury's ability to "tap" the issuance of specific securities also provides the regulator with a powerful tool and helps to ensure a liquid trading and financing market for Treasuries.

Finally, several members pointed out that the Treasury market is the most liquid and best functioning market in the world and that increased regulation might come at a cost and is not needed nor warranted.

In the final section of the charge, the Committee considered the composition of marketable financing for the July-September quarter to refund approximately \$22.4 billion of privately held notes and bonds maturing or called on August 15, 2006 as well as the composition of Treasury marketable financing for the remainder of the July-September quarter, including cash management bills, as well as the composition of Treasury marketable financing for the October-December quarter. To refund \$22.4 billion of privately held notes and bonds maturing August 15, 2006, the Committee recommended a \$21 billion 3-year note due August 15, 2009, and a \$13 billion 10-year note due August 15, 2016, and a \$12 billion reopening of the 30-year bond due February 15, 2036. For the remainder of the quarter, the Committee recommended a \$22 billion 2-year note in August and September, a \$14 billion 5-year note in August and September, and an \$8 billion reopening of the 10-year note in September. The Committee also recommended a \$25 billion 14-day cash management bill issued September 1, 2006 and maturing September 15, 2006 as well as a \$12 billion 8-day cash management bill issued September 7, 2006 and maturing September 15, 2006. For the October-December quarter the Committee recommended financing as found in the attached table. Relevant features

include three 2-year note issuances monthly, three 5-year note issuances monthly, one 3-year note issuance in November, a 10-year note issuance in November with a reopening in December, as well as a 5-year TIPs reopening in October and a 10-year TIPs reopening in October.

Respectfully submitted,

Thomas G. Maheras
Chairman

Keith T. Anderson
Vice Chairman

Attachments (2)
Table Q3
Table Q4